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Polish Weekly Review

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Comment on the upcoming data and forecasts

A light week ahead of us in terms of economic data. On Wednesday the CSO will publish the latest Statistical Bulletin along with unemployment data. Preliminary data from the Ministry of Labor and Social Policy suggests a smaller decline than originally forecast.

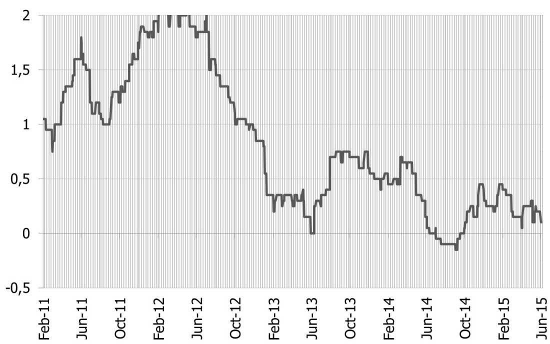
Polish data to watch: June 22th to June 26th

Publication	Date	Period	mBank	Consensus	Prior
Unemployment rate (%)	24.06	May	10.8	10.8	11.2

Treasury bonds and bills auctions

Paper	Next auction	Last Offer	Yield on the prev auction (%)	Prev auction
52 Week T-bills	-	3000	3.485	3/4/2013
2Y T-bond OK0717	-	1500	1.667	6/11/2015
5Y T-bond PS0720	-	3500	1.987	5/21/2015
10Y T-bond DS0725	-	2000	2.262	4/9/2015
15Y T-bond WS0428	-	20	2.092	3/12/2015

Reality vs analysts' expectations (surprise index* for Poland)



Comment

Several negative surprises but only one managed to move the index – CPI. Next week brings only one possible surprise - unemployment.

* Surprise index presents in a synthetic way how the market was surprised by macroeconomic releases (it is constructed on daily basis as weighted average of differences between selected releases and Bloomberg forecast consensus).

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Our view in a nutshell

Fundamentals

- We see more and more sings of a cyclical upswing driven by better momentum in the euro zone (Poland is highly geared especially towards Germany) and backed by solid domestic demand. GDP growth accelerates.
- H2 2015 is expected to bring more (positive) exogenous components to the Polish cycle. Lower costs of financing, generally lower budget deficit and the beginning of a new round of infrastructure spending are expected to give way to expenditures related to political business cycle ahead of general elections.
- Given the schedule of infrastructure spending and stable consumption growth, 2-3 years of economic expansion are our baseline scenario for Polish economy. Upswing phase can be flatter than we historically got used to but longer. Such an outcome almost guarantees that the likelihood of bottlenecks in the economy is small.
- Inflation recorded a slight turnaround and we await higher readings in coming months. However, output gap is too wide to generate inflation pressure and therefore inflation is going to stay low (very low). Prices are going to stay in deflation in the next 2 quarters.
- MPC did its part delivering 50bps cut in March. Official communication states that the cycle has been concluded and rates are going to stay at 1.5%. At the same time rate hikes are miles away since there is no inflation in sight and the new MPC (starting job in 2016) may be even more dovish.

Financial markets

- We turn tactically constructive on POLGBs via outright 10y long.
- Globally, the support for higher yields may be waning: elevated valuations in Europe (including full normalization of rates within 5y horizon, rates hikes in 2017) may be unsustainable given the loss of momentum in the real sphere, possible flattening of inflation path (higher EURUSD, loss of upward momentum in oil prices) and looming period of net negative supply of EGGB.
- Locally the story is more or less of the same sort: full normalization is priced in and 2-3 rate hikes come in already in 2016. That's too generous in our opinion whereas the steepness of the curve returned to normal (it is costly to pay rates), local investors seem to be underweight duration and foreign holders reduced long positions of late. Political risk is more or less priced in. Moreover, -ve election story seems to be slowly unwinding given uncertainties what exactly to expect in the Autumn. Last but not least, strong zloty and favorable external position of the economy shields POLGBs (already weak in terms of spread ag bunds and treasuries)from Greek and American risks; the former, however, run currently as high as never.
- Zloty should mimic POLGBs dynamics and overall prospects for the currency remain positive (high real rates, monotonic economic recovery).

mBank forecasts

	2010	2011	2012	2013	2014	2015F
GDP y/y (%)	3.7	4.8	1.8	1.7	3.4	3.9
CPI Inflation y/y (average %)	2.8	4.3	3.7	0.9	-0.1	-0.6
Current account (%GDP)	-4.5	-4.9	-3.5	-1.3	-1.2	-0.6
Unemployment rate (end of period %)	12.4	12.5	13.4	13.4	11.5	10.3
Repo rate (end of period %)	3.50	4.50	4.25	2.50	2.00	1.50

	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2 F	2015 Q3 F	2015 Q4 F
GDP y/y (%)	3.5	3.6	3.3	3.3	3.6	3.7	3.9	4.3
Individual consumption y/y (%)	3.0	3.0	3.2	3.0	3.1	3.1	3.1	3.3
Public Consumption y/y (%)	0.5	6.4	5.3	6.4	3.3	3.0	3.0	2.0
Investment y/y (%)	11.4	8.7	9.2	8.6	11.4	9.0	10.0	10.0
Inflation rate (% average)	0.6	0.2	-0.3	-0.7	-1.4	-0.9	-0.4	0.5
Unemployment rate (% eop)	13.9	12.0	11.5	11.5	11.7	11.0	10.2	10.3
NBP repo rate (% eop)	2.50	2.50	2.50	2.00	1.50	1.50	1.50	1.50
Wibor 3M (% eop)	2.71	2.68	2.28	2.06	1.65	1.68	1.69	1.69
2Y Polish bond yields (% eop)	3.01	2.51	2.00	1.79	1.61	1.70	1.80	1.70
10Y Polish bond yields (% eop)	4.23	3.45	3.05	2.52	2.31	3.00	3.20	2.90
EUR/PLN (eop)	4.17	4.16	4.18	4.29	4.07	4.10	4.10	4.05
USD/PLN (eop)	3.03	3.04	3.31	3.54	3.80	3.87	3.98	4.05

F - forecast

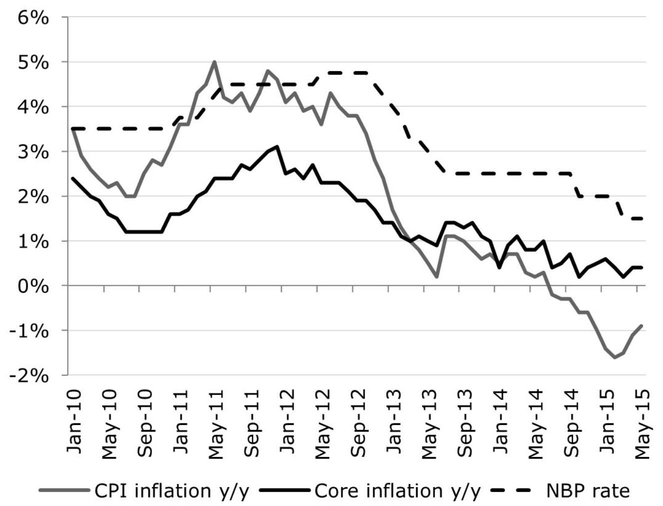
Economics

The economy lost momentum in Spring, again. The rationale for monetary tightening is conspicuously absent

Seen through the lens of May data, Polish economy seems healthy, albeit there is a visible loss of momentum – even if one stripped working day effects, post-winter paybacks, variable Easter effects and other statistical noise. As a result, 2015 is suddenly looking eerily like 2014, with a stellar first quarter and weaker momentum in the second. It is not a coincidence, in our view, that Polish industry shifted into lower gear at the same time as the euro area seemingly did. Stronger EUR, ever-slowing EMs and return to (almost flat) trend growth are reaching back through trade links, to Polish economy. It is not a boom - a conclusion worth repeating. At the same time, Poland is coming out of deflation more slowly than anticipated. The current rise in inflation might easily be overstated - momentum measures have barely turned and remain consistent with inflation running below 1%, not to mention the NBP's target. In such an environment the last refuge of the hawks is the paradigm of positive ex ante real interest rates, which demands a hike in the second half of 2016 to keep up with inflation rising to 2% and above in 2017 (consensus view). The new MPC might not agree, though.

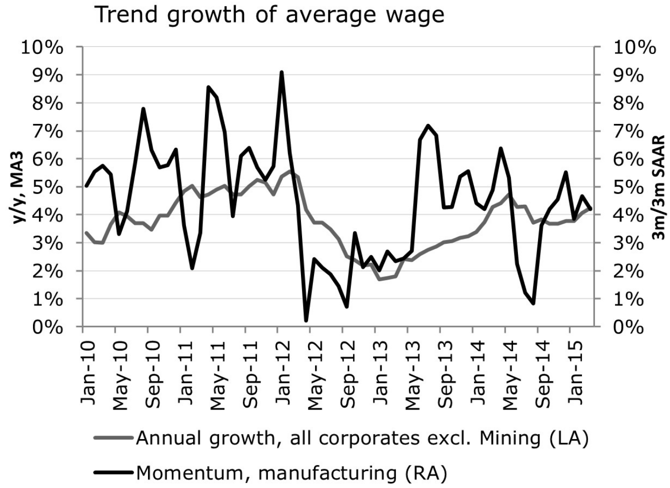
Here's our take on this week's releases.

In May **CPI inflation** in Poland grew from -1.1% y/y to -0.9%, significantly lower than market consensus, which was between -0.7% and -0.6%. Why coming out from deflation is much slower than expected? Main reason for this surprise is unusual, taking into account data from marketplaces as well as regional patterns (Hungary, Czech Republic, Romania), movement of food prices. Instead of rising, food prices fell in May by 0.1% m/m. Secondly, core categories were in our opinion extremely weak – from out estimates base inflation remained at previous month level (0.4% y/y). It is hard to put blame on any specific category, though. The rise in fuel prices (+1.3% m/m) was consistent with our forecast.

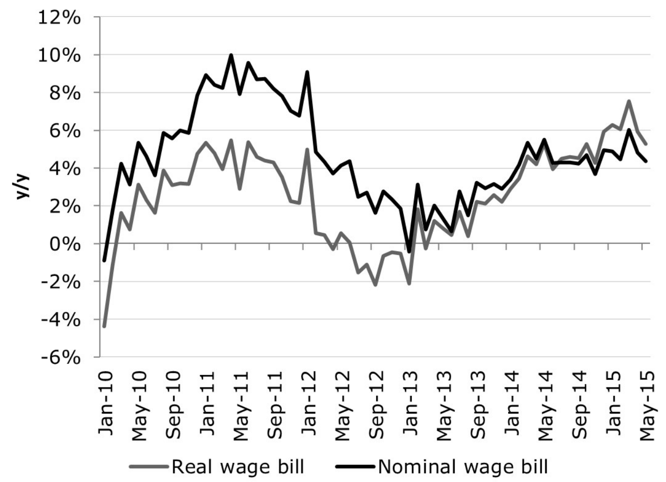


Next month, inflation should increase to ca. -0.6%. Apart from further increases in fuel prices, inflation should be boosted by food prices - as indicated by mounting evidence on significant growth of fruit prices (e.g. apples). Nevertheless, core inflation is still characterized by very low and barely positive momentum.

Wage growth slowed down from 3.7% in April to 3.2% y/y in May, in line with our forecasts and slightly below market consensus (3.7%). The slowdown is, however, only slight. Based on our own forecasts we suspect that the key culprit was slower growth in manufacturing wages (negative working day effect took its toll) and high statistical bases in construction and transport. In our view this deviation from trend (currently oscillating around 4%) is temporary in nature and should reverse itself next month. Due to calendar effects and different arrangement of statistical bases, June will probably bring a marked acceleration in wage growth (above 4%).

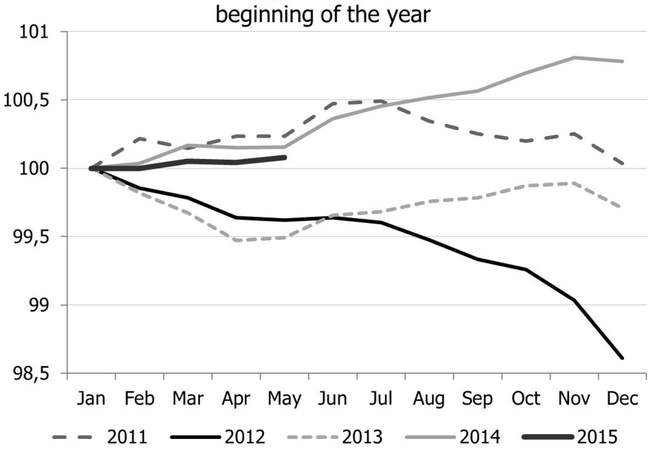


Nominal wage bill grew by 4.4% y/y in May (3.8% in April), in real terms the slowdown was a bit more severe (down from 5.9% to 5.3% in annual terms) because of the increase in inflation. As a result, real wage and real income growth appears to be normalizing (i.e. returning to 2014 levels). Will this development impact consumption growth? We do not think so. The "boom" in real incomes seen in the first months of the year had no discernable effect on consumption (as it seems stuck at 3% growth lately), it is unlikely that the reversal will dampen consumer spending.



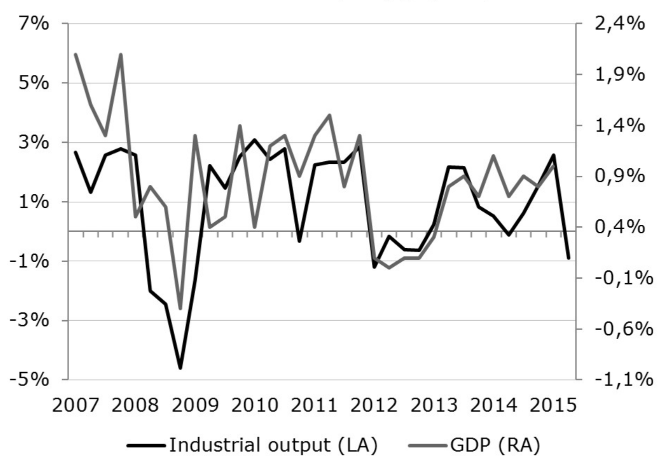
Employment in enterprise sector rose in May by 2k month over month, which resulted in 1,1% growth on a yearly basis – in line with our forecast and market consensus. Even though we still have to wait for details, it seems that industry (except few sectors which add 1-2k jobs depending on business cycle) is close to full employment (not from an economic point of view) with current wages, capital and GDP growth (with exception of some "dying" sectors). Gyrations will now mainly by generated by seasonal sections: construction, trade, transport and mumbo-jumbo hidden under the name of administration and supporting activities. We think that average employment growth pace in employment sector has slowed to 1-4k monthly in cycle. Because of strong seasonal effect in June we would probably see a huge upward spike in monthly rate of change, not certainly meaning an acceleration on a yearly basis. Employment growth is mainly carried out outside enterprise sector, in companies employing less than 9 person (according to CSO taxonomy) and in the public sector. As we have been pointing out, new jobs created outside public sector have rather poor quality, which results in weak employees bargaining power and low consumption stability of households with vast part of income from this type of jobs.

Cumulative change in employment since the beginning of the year



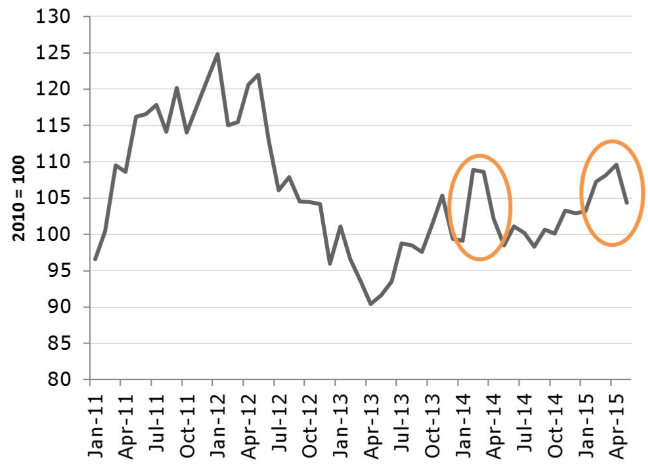
In May, **industrial output** grew by 2.8% y/y after 2.3% growth in April (when it was underestimated due to one off effects, including the timing of Easter). The figure was weaker than most forecasts and lower than the one implied by working days and normalization in food production (the aforementioned reversal of Easter effect). After seasonal adjustments output grew by 5.3% y/y and 0.9% m/m (but mainly because of mining). The momentum of industrial output weakened in the second quarter – this remains consistent with the behavior of analogous aggregates in the euro area (EM slowdown + fading impulse from EUR depreciation). 22 out of 34 industries recorded positive y/y growth in May (down from 26 in the previous month). The list of those is a mix of export – and domestic-oriented sections.

GDP and industrial output (q/q, SA)



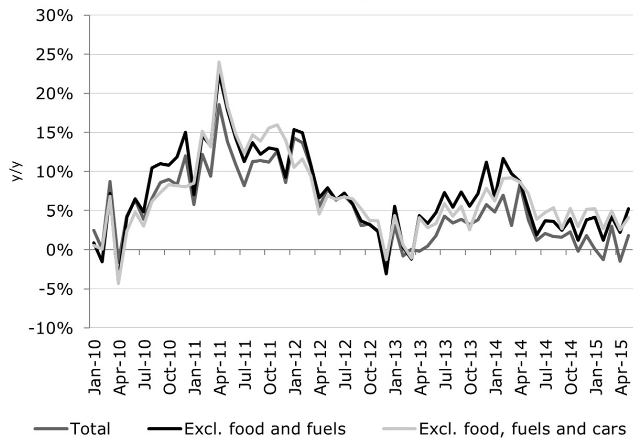
Construction output unexpectedly slowed down on annual basis - from 8.5% to 1.3% (significantly below consensus). After seasonal adjustments construction output growth amounted to 4.8% y/y and -4.4% m/m (the biggest monthly decline in more than a year). The reasons for such a significant slowdown are unclear to us at this point, though it is clear that neither calendar effects, nor the weather are to blame. Most likely, negative payback from an unusually warm winter was larger than anticipated - after all, output is back to January levels (the same happened last year, albeit on a smaller scale). Having said that, we stand firm by our positive view on construction – new binge in infrastructural investment should appear on schedule.

Construction output, volume index



Retail sales re-accelerated in May to 1.8% y/y from -1.5% in April. It does not look spectacular and should not be treated this way. It is hard to see more than just a normalization after the weak April dampened by the timing of Easter. Looking at our favorite stripped aggregates (see the graph) retail sales exhibits sea-saw tendency i.e. goes sideways. Private consumption comprises mostly of services.

Retail sales in current prices



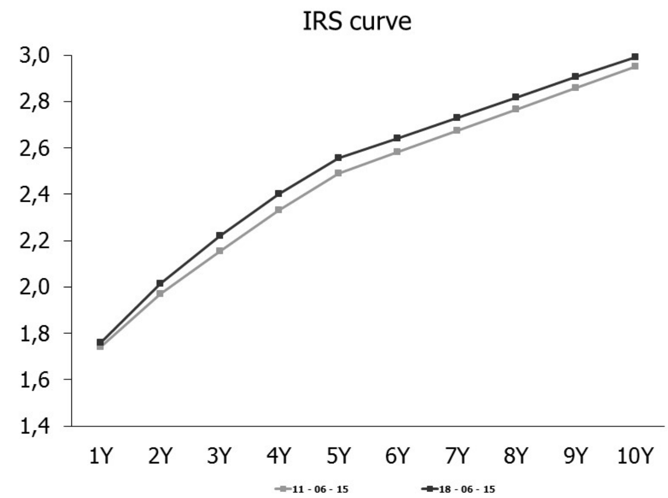
The aforementioned normalization after Easter can be seen in case of food sales (+2.4% y/y vs -2.9% recently) and partly in car sales (+11.4% y/y vs flat reading in April). Rises in fuel prices added round 0.5pp to the whole growth in retail in May. Durable goods and semi-durable ones trend sideways in growth terms. We do not see any signs that could prove the change in trend from sideways to rising. We stick then to our scenario of meager consumption growth in this cycle of around 3%.

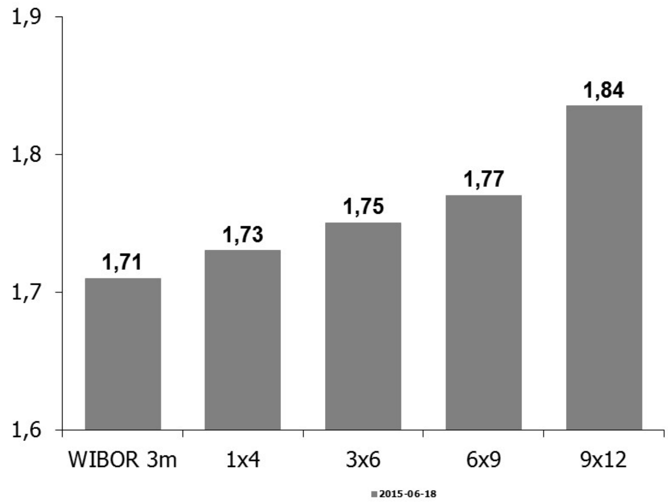
Fixed income

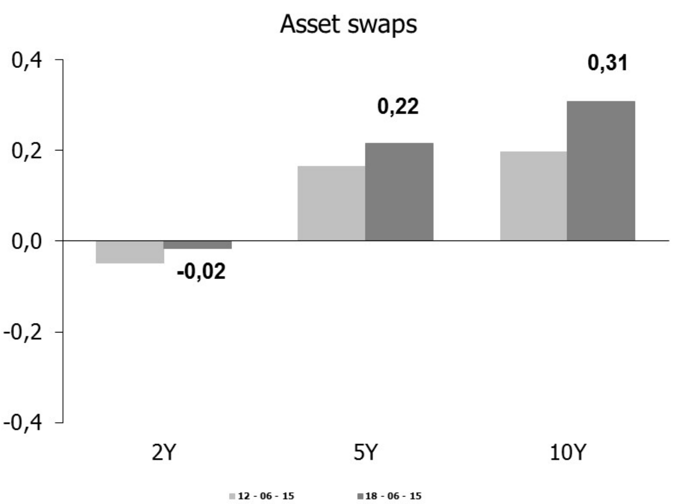
It’s all about Greece

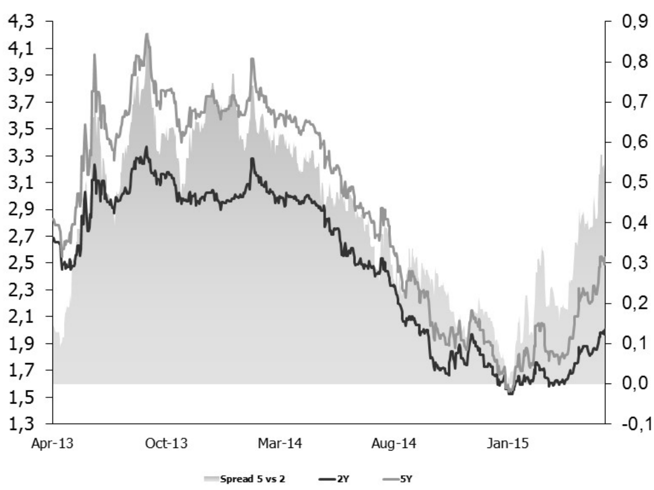
With Greek politicians trying to pull the wool over whole world’s eyes, the market started to be more and more nervous. During the first part of the week selling interests have intensified, with low liquidity DS0725 reached 3,39%; PS0420 – 2,62%. Some relief came with FOMC meeting on Wednesday as Fed statement and conference was clearly in a dovish tone (DS0725 yield fell back to 3,22%).

We believe that from the fundamental point of view valuations of POLGBs are too low in price terms (we take into account political risk related to parliamentary elections in October), however, everybody knows that any relief rally needs s deal reached with Greece and this should be known during the next few days.









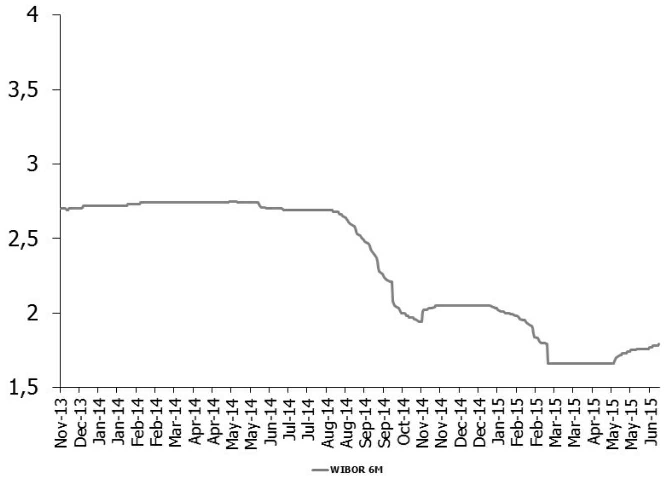
Money market

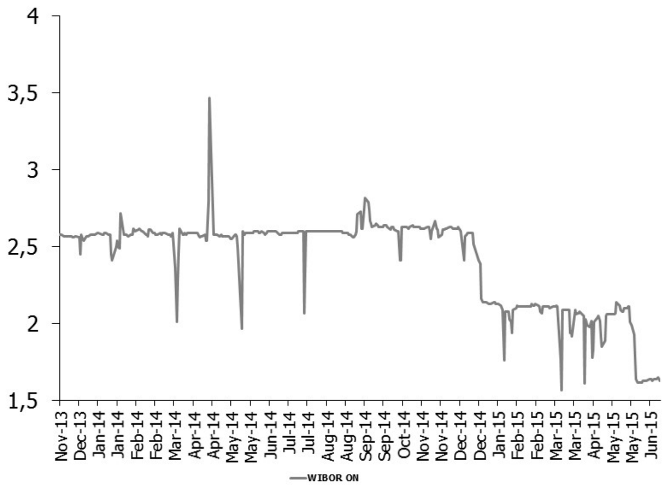
Expensive week behind us

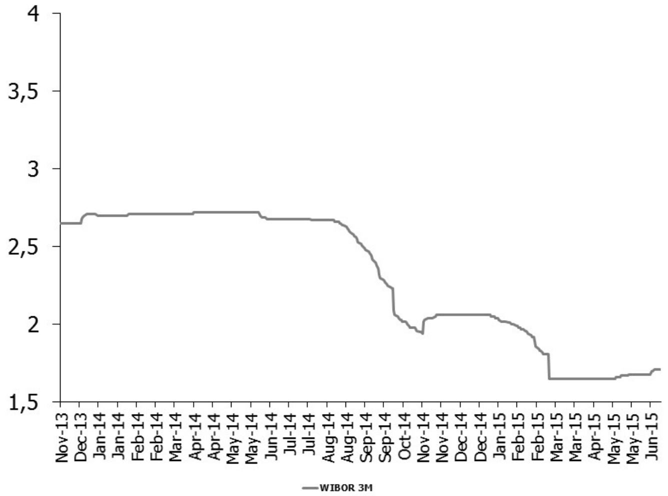
It was expensive. Last week Polonia fluctuated above reference rate as market get a bit short in cash. Next one should be stable with cash rate around 1.50 as today's OMO was underbid by 1.5 bn PLN.

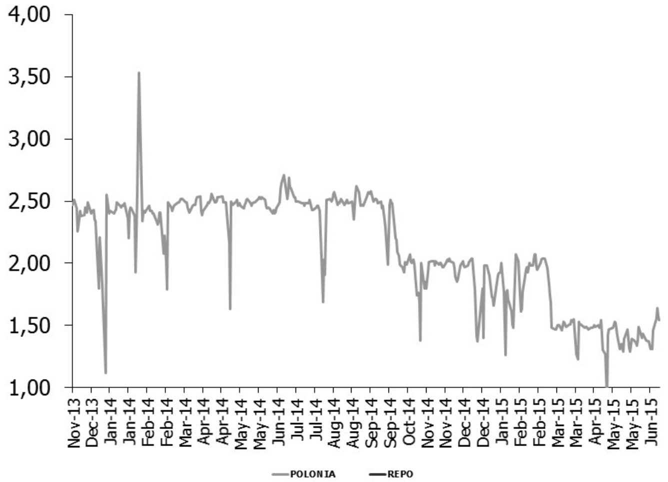
After bearish beginning of the week longer rates came back to levels from last week. We don't believe in any rate hikes so we recommend to sell whole front end and buy bonds especially after last CPI data (-0.9 vs -0.7 expected). Only risk for derivatives are WIBORs which might rise without any rate hikes.

Sell 1Y OIS POLONIA at 1.55.





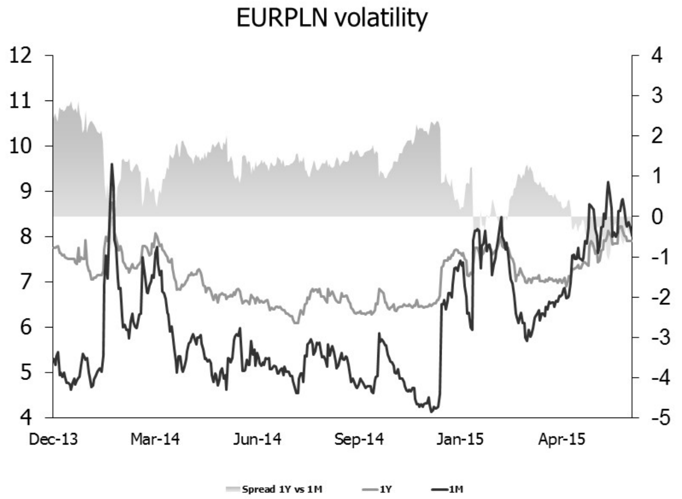




Forex

PLN – weaker PLN gains from last week have already evaporated. EUR/PLN moved from 4.1270 low last week to 4.1770 high (this week). It is worth noting that we had dovish (zloty positive) FOMC on the way, which in theory should give boost to all EM currencies. The answer why we have overall weaker PLN, should the most probably be Greece. The cacophony of contradicting information makes the market immune to react but the tensions are rising. We are still prone to look at EUR/PLN from the 4.10/4.20 range perspective, but it is the upside that could potentially produce fireworks.

OPT – vols lower, again Lower realized volatility, calmer markets, dovish FOMC were the reasons why the vols kept on sliding lower. 1 month EUR/PLN ATM is this Friday 7.7% mid (0.3% lower). 3 months EUR/PLN are 7.8% (0.2% down) and finally 1y is fixing at 7.8% (0.1 lower). The Skew was roughly unchanged. The real rollercoaster was on currency spread (difference between USD/PLN vol and EUR/PLN vol). It was sold aggressively after FOMC only to be bought back after more alerting Greece headlines.



Short-term forecasts

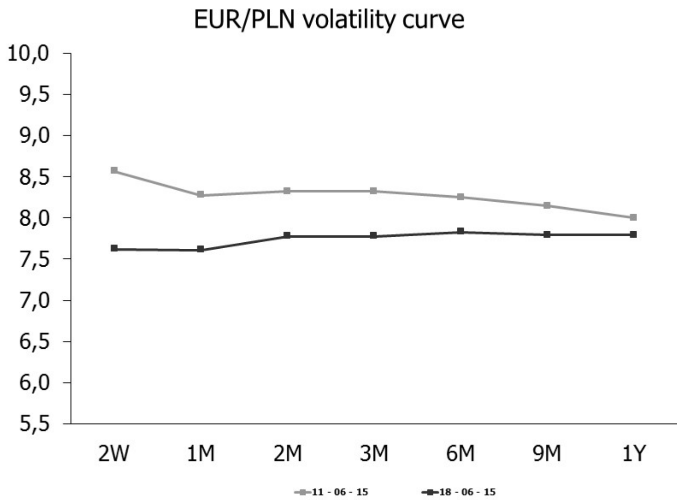
Main supports / resistances:
EUR/PLN: 4.09 / 4.19
USD/PLN: 3.50 / 3.80

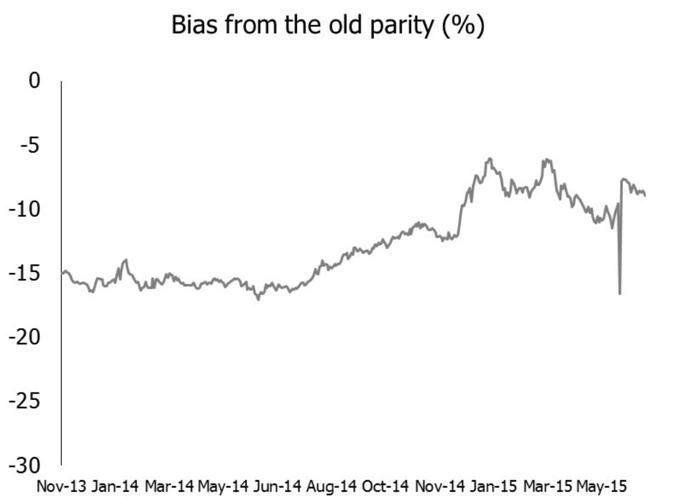
Position Still sidelined in EUR/PLN.

USD/PLN â€“ Unchanged from last week. FOMC has produced unpleasant an surprise for our position. Nevertheless, we still are long USD/PLN at 3.6600, we are ready to add at 3.6300 and set stop below at 3.6100. We would like to take profit at 3.8000.

Greece is a reason we have decided to be long USD/PLN.

Options We still long EUR/PLN and USD/PLN Vanna, (in 1 to 2 ratio in favor of USD/PLN). We are also long longer term Vega in both. We are ready to add to long Vega in back. We think that Greece, rate hikes in US, and parliamentary elections in Poland will support volatility in the longer term.





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Market prices update

Money market rates (mid close)								FRA rates (mid close)				
Date	FXSW 3M	WIBOR 3M	FXSW 6M	WIBOR 6M	FXSW 1Y	WIBOR 1Y	1x4	3x6	6x9	9x12	12x15	6x12
6/11/2015	1.48	1.70	1.63	1.67	1.93	1.71	1.72	1.73	1.75	1.82	1.90	1.84
6/15/2015	1.64	1.71	1.77	1.68	1.93	1.72	1.73	1.76	1.79	1.84	1.99	1.88
6/16/2015	1.71	1.71	1.68	1.68	1.96	1.72	1.74	1.75	1.78	1.86	1.95	1.88
6/17/2015	1.50	1.71	1.57	1.68	1.61	1.72	1.74	1.76	1.78	1.84	1.96	1.87
6/18/2015	1.71	1.71	1.79	1.69	1.70	1.72	1.73	1.75	1.77	1.84	1.94	1.87

Last primary market rates							
Paper	Au. date	Maturity	Avg. price	Avg. yield	Supply	Demand	Sold
52W TB	3/4/2013	8/28/2013	98.33	3.49	3000	7324	3084
OK0716	4/23/2014	7/25/2016	93.51	3.02	800	2136	836
PS0719	5/8/2014	7/25/2019	99.25	3.41	4000	5807	4075
DS1025	6/5/2014	7/25/2025	94.90	3.82	2000	2743	1693

Fixed income market rates (closing mid-market levels)								
Date	1Y WIBOR	1Y T-bill	2Y IRS	OK0715	5Y IRS	PS0718	10Y IRS	DS1023
6/11/2015	1.710	1.767	1.970	1.938	2.490	2.619	2.950	3.142
6/15/2015	1.720	1.799	2.035	1.999	2.610	2.800	3.075	3.333
6/16/2015	1.720	1.822	2.015	2.002	2.590	2.817	3.045	3.322
6/17/2015	1.720	1.846	2.025	1.994	2.595	2.811	3.030	3.340
6/18/2015	1.720	1.793	2.013	1.997	2.554	2.771	2.993	3.300

EUR/PLN 0-delta stradle					25-delta RR		25-delta FLY
Date	1M	3M	6M	1Y	1M	1Y	1Y
6/11/2015	8.28	8.33	8.25	8.00	8.00	2.14	0.55
6/15/2015	8.33	8.10	7.95	7.90	7.90	2.14	0.55
6/16/2015	8.20	7.98	7.95	7.90	7.90	2.17	0.56
6/17/2015	8.03	7.94	7.96	7.91	7.91	2.17	0.59
6/18/2015	7.61	7.78	7.83	7.80	7.80	2.13	0.56

PLN Spot performance						
Date	EURPLN	USDPLN	CHFPLN	JPYPLN	HUFPLN	CZKPLN
6/11/2015	4.1481	3.6817	3.9352	2.9801	1.3263	0.1522
6/15/2015	4.1486	3.6905	3.9665	2.9880	1.3261	0.1519
6/16/2015	4.1595	3.6933	3.9654	2.9890	1.3290	0.1524
6/17/2015	4.1535	3.6873	3.9815	2.9772	1.3302	0.1522
6/18/2015	4.1615	3.6556	3.9817	2.9761	1.3390	0.1527

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